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OSFI BSIF

FROM THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS CANADA (OSFI)

Pillar

Basel 2 implemented in Canada

The following article includes excerpts from two speeches given by Superintendent Julie Dickson: remarks to the Langdon Hall Life Insurance Forum on November 15, 2007 and remarks to the KPMG Insurance Issues Conference, November 22, 2007.

It should be noted that Basel 2 for banks came into effect in Canada on November 1, 2007. We did not make a splash about it because, frankly, it is simply part of good risk management.

Basel 2 is a journey, not an event like Y2K where you know as soon as the switch is turned on whether you have succeeded or not. We are only going to know how successful we have been as risk management processes become richer, as the quality of stress testing improves, as more data is generated, as models are back tested, and as decisions about risk management are made. Basel 2 is all about thinking, not box ticking.

Insurers want their own version of Basel 2 (known as Solvency 2), and now both life companies and P&C companies are moving forward down the Solvency 2 road. But it is not an easy road to travel. There were challenges the banks had in getting to the implementation date for Basel 2 – and insurers are going to have exactly the same challenges. With that in mind, here are ten of the challenges that OSFI identified on the road to Basel.

First, banks worldwide said that adopting Basel 2 was not a problem – they could do the models and all was in place and regulators just needed to look at what banks were doing and approve. That was several years ago.

Superintendent Julie Dickson

Then they began to realize that the work needed to move to the leading edge of risk management was significant – certainly not a slam dunk. Organisational and cultural shifts were necessary and the associated change management took time and resources; the scale of implementation effort and communication was much bigger that expected.

(cont'd page 2)

OSFI Superintendent announces new executive member

Asst. Superintendent Coleen Volk

On November 28, 2007, the Superintendent of Financial Institutions, Julie Dickson, announced the appointment of Coleen Volk as Assistant Superintendent, Corporate Services Sector.

Most recently, Ms. Volk was Assistant Deputy Minister, Corporate Services Branch with the Department of Finance, where she directed corporate services for Finance Canada and the Treasury Board Secretariat and served on the executive management committees of both departments.

Prior to joining the Department of Finance, Ms. Volk was at Canada Mortgage and Housing Corporation (CMHC), where she held various corporate finance positions, including Deputy Treasurer, Treasurer, Managing Director, Securitization, and Assistant Vice-President of Finance and Corporate Services.

Before joining CMHC, Ms. Volk spent eight years with two major banks in Toronto, working in the areas of financial systems, corporate finance and treasury and risk management.

To view the complete text of the announcement, visit the OSFI Web site at: www.osfi-bsif.gc.ca

Continued from page 1 — Second, banks felt that costs would be in a certain range. It turned out that costs were far higher, primarily because of the system builds required to integrate risk systems with financial systems.

Third, data was a real challenge. Banks had legacy systems, as do all financial institutions. Legacy systems are an issue when trying to do a Basel 2 type project because you need a sufficient quantity and quality of historical data in order to run your models, and to support your assessments of risk and your conclusions about capital. Legacy systems with potential overlaps and duplication in data sources can make that very difficult.

Fourth, large Canadian banks are international and they operate in many countries. Adopting advanced capital approaches in countries with far-flung material operations is a huge challenge. Also, when supervisors in other jurisdictions are not as far along the path, additional challenges are created that will need to be navigated by institutions and home supervisors. This is probably a greater challenge in the life insurance world than it was in the banking world.

Fifth, the "use" test was extremely difficult to meet. A bank actually has to use the results of its models in its decision making processes.

Sixth, establishing an independent review process for models within banks was a challenge, but a key supervisory expectation. It all boiled down to what constituted an independent group within a bank, what skills would be sufficient, what scope of work would be necessary, and how this work would be coordinated with the development/build effort in the business.

Seventh, producing a reasonable risk estimate to support a capital measurement was a huge challenge. Credit risk measurement is inherently tricky, as data is sparse and outcomes sensitive to underlying assumptions.

Eighth, explaining to senior management and directors what you were doing was not easy. Basel requires that your senior management and board know what the process is about. If it is considered to be the domain of rocket scientists safely ensconced in the bowels of an institution, you will not get a passing grade.

Ninth, there was confusion about the ultimate goal. Some institutions believed the Basel goal was a capital reduction or that it was simply a form of regulatory compliance. But a capital reduction is not necessarily the result; instead it is more risk-sensitive capital. Seeing it as a regulatory compliance exercise also misses the point, as it is about better risk management through the increasing use of institutions' own internal systems and controls.

Tenth, we all talked about Pillar 3 and the benefits of more disclosure. But there is a steep learning curve for analysts as well as for the institutions that implement the advanced approaches, and you need to build that in.

So these are some challenges. I am not trying to dissuade any companies from going down this road, because it is where companies need to go. But I think companies need to start the journey with their eyes wide open.

While Basel 2 for banks was highly criticized over the years as too complex or too costly, which led to significant delays in its adoption, it is interesting to see that the tide has turned and now many are saying that, had it been implemented earlier, global banks would have been better positioned for the global market turmoil they are facing now. So this may be a lesson learned from Basel: adopting new standardized approaches and advanced approaches can be time consuming and costly, but it is better to face the music and get it done, because it is all about better risk management and it is better to tackle such issues when times are good.

Basel I Reporting at Q1 2008

When Basel II Capital Adequacy Reporting (BCAR) is implemented in the first quarter of 2008, OSFI will no longer require institutions to file Basel I capital returns (G3 Capital Adequacy and M3 Capital Adequacy Market Risk) electronically.
However, OSFI expects institutions to retain the ability to produce a Basel I capital adequacy calculation as set out below:

1. IRB institutions should retain the ability to produce a Basel I capital calculation as long as a floor based on Basel I rules remains in place. This calculation should be at a level of detail comparable to the Basel I return and allow OSFI to review Basel I ratios included in the BCAR Schedule 1 memo item.

2. Institutions adopting the Standardized Approach have been invited to participate in a parallel run period in Q3 and Q4 2007. If an institution does not participate in the parallel run and cannot file acceptable standardized BCAR returns, the institution should also be prepared to provide OSFI with Basel I capital calculations until advised otherwise. The calculations should be at a level of detail comparable to the Basel I return, to allow OSFI to assess the capital strength of the institution.

3. The capital test for foreign bank branches is the Capital Equivalency Deposit. Effective Q1 2008, foreign bank branches are no longer required to prepare or submit schedules CAR 3 and CAR 4 of the G3 Capital Adequacy return.

To view the complete document, visit the OSFI Web site at: www.osfi-bsif.gc.ca

FIGHTING FINANCIAL CRIME:
The role of the Canadian financial sector

Keynote Address by Nicolas W. R. Burbidge to the Money Laundering in Canada 2007: Adding Knowledge and Building Skills Conference

Nicolas Burbidge
Director—Compliance

In thinking about domestic and international developments in the fight against money laundering (ML) and terrorist financing (TF) over the past few years, I specifically want to address why the fight against ML and TF is so important; the vital role of the financial sector; the effectiveness of our preventative measures, and last but not least, the importance to OSFI of the risk-based approach in implementing those measures.

When you think about it, virtually all crime has some sort of financial benefit to the perpetrator. Sure, some crimes of passion, carried out in the heat of the moment, may be exceptions, but the experts tell us that most criminal acts are done for money.

The 2007 Annual Report of the Criminal Intelligence Service Canada indicates that it has identified about 950 organized crime groups in Canada, compared to around 800 in 2006. Even when you take into account enhanced reporting, this still represents a very significant increase.

The report highlights the deleterious effect organized crime has on society, including the use of firearms, the manufacture and marketing of illegal drugs, the trafficking of persons and counterfeit products, contraband, and financial crime.

The Report estimates that between $22 billion and $55 billion is laundered annually in Canada. In reality, it is very difficult to know with any precision how much money is laundered here, or in other countries. Everyone seems to agree, however, that the volumes of illicit funds are very large.

Of course, there are many players involved in the fight against ML: law enforcement, prosecutors, policy makers and elected officials. We in the financial sector are key players as well, whether we are regulators or financial institutions. But, immersed as we often are in the minutiae of administering AML compliance and risk management measures, it is easy sometimes to lose track of why what we do is so important.

At a high level, the role of the financial sector is basically twofold.

First, the financial sector must be able to detect activity or transactions that seem suspicious and report on them to the authorities.

You might not know for sure that funds in your custody are the proceeds of crime, but you can increase the chances of identifying suspicious activity by thoroughly understanding who your clients really are, what types of transactions they would be ordinarily engaged in, and where those transactions would normally be processed.

I am, of course, talking about a solid client profile. Without this base knowledge, the huge sums of money that the financial sector is spending each year on monitoring transactions would be largely ineffectual. How can you tell if something is suspicious if you don't know what normal looks like?

Second, the financial sector must ensure that good records are kept about customers. Clearly, good information is a key underpinning for meaningful intelligence reporting.

If financial institutions do spot activity that needs to be reported to FINTRAC, it is important that they are able to provide accurate and up-to-date information about the person or persons who conducted the transaction, and what made the institution suspicious. And, in the event that law enforcement needs to see documentation, accurate and complete data will help the authorities to mount a solid case for prosecution.

To view the complete remarks, visit the OSFI Web site at: www.osfi-bsif.gc.ca

Financial Action Task Force (FATF) Statement on Iran

In an October 11, 2007 statement, the Financial Action Task Force (FATF) announced that it is concerned that the Islamic Republic of Iran's lack of comprehensive anti-money laundering / combating the financing of terrorism (AML/CFT) regime represents a significant vulnerability within the international financial system. The FATF has called upon Iran to address, on an urgent basis, its AML/CFT deficiencies, including those identified in the 2006 International Monetary Fund Article IV Consultation Report for Iran. The FATF has further indicated that it looks forward to engaging with Iran to address these deficiencies

The statement also says that FATF members are advising their financial institutions to take the risk arising from the deficiencies in Iran's AML/CFT regime into account for enhanced due diligence. Canada has been a member of the FATF since its inception in 1989.

The text of the FATF statement can be found at:
http://www.fatf-gafi.org/dataoecd/1/2/39481684.pdf

Accordingly, financial institutions should give heightened attention to transactions related to Iran, and are also reminded of their obligations under Canada's Regulations Implementing the United Nations Resolution on Iran.

For further information on these Regulations, please refer to OSFI's website at: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=1720

To view the complete document, visit the OSFI Web site at: www.osfi-bsif.gc.ca

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What's New Online (www.osfi-bsif.gc.ca)

OSFI 2006-2007 Annual Report

The OSFI 2006-2007 Annual Report, Charting a Course, has been tabled in Parliament.

Actuarial Report (23rd) on the Canada Pension Plan

The twenty-third Actuarial Report of the Canada Pension Plan has been tabled in Parliament. It presents the financial status of the Plan as at 31 December 2006.

OSFI releases a new Regulatory and Legislative Advisory on Control in fact

This Advisory addresses the issue of whether a person controls an entity, as it is relevant in various circumstances throughout the federally regulated financial institution (FRFI) statutes.

Instruction Manual Update for Deposit Taking Institutions (Effective January 2008)

An update on the changes that have been made to the Financial Information Committee (FIC) regulatory returns and instructions.

To view the complete text of these documents, visit the OSFI Web site at:
www.osfi-bsif.gc.ca

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